

## 2.04 Revenue Recognition Step 4

### 4. Allocate Transaction Price to Performance Obligations in the Contract

The total consideration from a contract is allocated to all performance obligations in proportion to their standalone selling prices. The **standalone selling price** is the price the entity sells a good or service for separately in comparable transactions. If they sell it separately, we have an *observable price*, so we can use that price as the best evidence of the standalone price.

However, if they don't sell them separately, then we must estimate the standalone selling price (as of date of the *inception* of the contract) using one of the following *three approaches*:

- **Adjusted market assessment** – Evaluate the market, see what a customer might be willing to pay or also look at competitors.
- **Expected cost plus a margin** – Forecast expected costs and add an appropriate profit margin for that good or service.
- **Residual value method** – Use only if either:
  - Some goods/services are sold for different amounts to different customers; or
  - The good/service has not previously been sold as a standalone product or service and a price has not yet been set.

### Discounts in General

Discounts, equal to difference between the total of standalone sales prices and total consideration, are generally allocated proportionately among performance obligations. However, discounts may be allocated to some but not all performance obligations when four criteria apply:

- Each distinct good or service in the contract is also sold as a standalone good or service on a regular basis;
- Some distinct goods and services are also sold as a bundle at a discount;
- The discount on the contract is comparable to the discount on the distinct goods and services sold in a bundle at a discount; and
- If allocated to some but not all performance obligations, the residual approach is not applied until after the discounts have been allocated.

An entity enters a contract to provide a software license, installation, and three years of tech support as a bundle for \$70,000. They use the following information to determine standalone prices:

- The entity would normally sell the software license for \$50,000.
- They don't normally sell the installation, but their competitors sell it for \$10,000.
- They also don't have a price for the tech support. They estimate that it will cost them \$32,000 and they would like to make a profit of 25% on top of that, so the standalone selling price for tech support is \$40,000 ( $\$32,000 \times 1.25$ ).

Thus, the total of the standalone selling prices is \$100,000. Since the entity is selling the bundle for \$70,000, this represents a \$30,000 discount. Also, there is no observable evidence that indicates that the discount relates to any particular product; therefore, the discount will be allocated by allocating the total revenue to the different products based on their relative standalone selling prices.

Product	Method Used	Standalone Selling Price	Allocation Calculation	Price Allocation
Software license	Observable price	\$50,000	$50/100 \times 70,000$	\$35,000
Installation	Adjusted market assessment	10,000	$10/100 \times 70,000$	7,000
3 years tech support	Expected cost plus margin	<u>40,000</u>	$40/100 \times 70,000$	<u>28,000</u>
Total		<u>\$100,000</u>		<u>\$70,000</u>

Now assume all the same facts as in the last example, except that there is no observable price nor another estimated price for the tech support. In this case, the price for the tech support will simply be the remaining amount of the transaction price after subtracting the two prices that are known/estimated.

Product	Method Used	Standalone Selling Price	Calculation	Price Allocation
Software license	Observable price	\$50,000		\$50,000
Installation	Adjusted market assessment	10,000		10,000
3 years tech support	Residual value	<u>XX,XXX</u>	$70K - 50K - 10K$	<u>10,000</u>
Total		<u>\$70,000</u>		<u>\$70,000</u>

## Discounts in a Multiple Element Arrangement

In a *multiple element arrangement*, if a bundle of goods is sold at a discount and is also included in a bigger bundle with a discount that exceeds the one on the smaller bundle, the discounts are allocated on a **step basis**.

- Step 1 – First, the discount that applies to the smaller bundle will be allocated among the items in that bundle.

- **Step 2** – Next, the remaining discount is allocated among all items using:
  - The standalone sales prices for those items that were not included in the smaller bundle, and
  - The *adjusted* standalone sales prices (ie, standalone sales price – first discount) of the items in the smaller bundle.

There is another store that sells **recreational vehicles**. There is a water package that consists of a jet ski with a normal standalone sales price of \$2,900 and a motorized raft with a normal standalone sales price of \$3,600. They can be purchased in a bundle for \$5,525. In addition, they sell a small off-road motorcycle with a normal standalone sales price of \$2,800 and a snowmobile that has a normal standalone sales price of \$3,000; these items are being bundled as the off-road package for a total of \$5,220. The store also sells a larger bundle, consisting of all four items in their sportsman's package at a total cost of \$10,100.

To determine how the \$10,100 will be allocated, the discounts will be allocated on a step basis. The water package includes the jet ski with a normal standalone sales price of \$2,900, and a motorized raft with a normal standalone sales price of \$3,600, for a total of \$6,500. With a bundle price of \$5,525, there is a discount associated with that bundle of \$975, which is 15% of the total of the standalone sales prices. As a result, the discount on the jet ski will be  $15\% \times \$2,900$ , or \$435, resulting in an adjusted standalone sales price of \$2,465. The motorized raft will have a discount of  $15\% \times \$3,600$ , or \$540, resulting in an adjusted sales price of \$3,060 and a total for the water package of \$2,465 + \$3,060, or \$5,525. Alternatively:

Water Package				
Product	Standalone Selling Price	Allocation Calculation	Price Allocation (Step 1)	Discount
Jet ski	\$2,900	$2,900/6,500 \times 5,525$	\$2,465	\$435
Motorized raft	<u>3,600</u>	$3,600/6,500 \times 5,525$	<u>3,060</u>	<u>\$540</u>
Total	<u>\$6,500</u>		<u>\$5,525</u>	<u>\$975</u>

The off-road package consists of the motorcycle at \$2,800 and the snowmobile at \$3,000, for a total of \$5,800. The bundle price is \$5,220, there is a discount of \$580, which is 10%. Thus, the discount allocated to the motorcycle will be  $10\% \times \$2,800$ , or \$280, resulting in an adjusted price of \$2,520. The discount allocated to the snowmobile will be  $10\% \times \$3,000$ , or \$300, resulting in an adjusted standalone sales price of \$2,700. The total for the off-road package is \$2,520 + \$2,700, or \$5,220. Alternatively:

Off-road Package				
Product	Standalone Selling Price	Allocation Calculation	Price Allocation (Step 1)	Discount
Motorcycle	\$2,800	$2,800/5,800 \times 5,220$	\$2,520	\$280
Snowmobile	<u>3,000</u>	$3,000/5,800 \times 5,220$	<u>2,700</u>	<u>\$300</u>
Total	<u>\$5,800</u>		<u>\$5,220</u>	<u>\$580</u>

The two packages combined would then be  $\$5,525 + \$5,220$ , or  $\$10,745$ . Since the package can be purchased for  $\$10,100$ , there is a discount of  $\$645$ ; this is 6% of  $\$10,745$ . Thus, the additional discount to be allocated to the jet ski would be  $6\% \times \$2,465$ , or  $\$148$ , adjusting the price to  $\$2,317$ . The discount allocated to the motorized raft would be  $6\% \times \$3,060$ , or  $\$184$ , resulting in an adjusted price of  $\$2,876$ . The discount allocated to the motorcycle would be  $6\% \times \$2,520$ , or  $\$151$ , resulting in an adjusted price of  $\$2,369$ . The discount allocated to the snowmobile would be  $6\% \times \$2,700$ , or  $\$162$ , for an adjusted price of  $\$2,538$ . Thus, the total consideration would be allocated as follows:

Sportsman's Package				
Product	Adjusted Standalone SP	Allocation Calculation	Price Allocation (Step 2)	Discount
Jet ski	<u><math>\\$2,465</math></u>	$2,465/10,745 \times 10,100$	<u><math>2,317</math></u>	<u><math>\\$148</math></u>
Motorized raft	<u><math>3,060</math></u>	$3,060/10,745 \times 10,100$	<u><math>2,876</math></u>	<u><math>184</math></u>
Motorcycle	<u><math>2,520</math></u>	$2,520/10,745 \times 10,100$	<u><math>2,369</math></u>	<u><math>151</math></u>
Snowmobile	<u><math>2,700</math></u>	$2,700/10,745 \times 10,100$	<u><math>2,538</math></u>	<u><math>162</math></u>
Total	<u><math>\\$10,745</math></u>		<u><math>\\$10,100</math></u>	<u><math>\\$645</math></u>

## Allocation of Variable Consideration

Variable consideration may relate to the entire contract or only part of it, such as one or more performance obligations or, more specifically, one or more goods/services. For example, variable consideration:

- May relate to a single performance obligation, such as a bonus for timely performance.
- May be an increase in the cost to be incurred in satisfying a performance obligation.

Variable costs/revenues (ie, consideration) are generally required to be allocated to all performance obligations on the same basis as the allocation of other consideration. However, they may be allocated to specific performance obligations or specific goods/services if two criteria apply:

- The variable payment is associated with
  - The entity's *efforts* to satisfy a specific performance obligation or to deliver a distinct good/service, or
  - The *outcome* from satisfying such obligation.
- Allocation of the entire amount of variable consideration is **consistent** with the objectives of the standard with regard to the allocation of transaction price to performance obligations (ie, the amount allocated is the amount the entity expects to be entitled to for that performance obligation).

For example, it would be appropriate to not allocate the variable consideration to the entire contract when the contract calls for granting the use of:

- License A for \$800 (fixed amount) and
- License B for 5% royalties based on the customer's sales related to the license (variable consideration). The royalties are expected to amount to \$1,000.

Allocating the entire amount of variable consideration to only License B makes sense because it is (1) related to the use of the license (ie, the outcome) and (2) the amount represents the consideration the entity expects to receive for that particular performance obligation.

**Price changes** are dealt with similarly to variable consideration. The same criteria as applied to variable consideration applies for purposes of allocating a price change to a specific performance obligation or good/service, but not the entire contract. Otherwise, they are allocated to all distinct performance obligations on the same basis as total consideration using standalone selling prices.

- Changes to standalone selling prices are not considered.
- May result in allocation to performance obligations already satisfied. Portions allocated to performance obligations already satisfied are taken into income immediately.